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IN THE

Supreme Court of the United States

October Term, 1940.

No. 120.

HOWARD S. PALMER, JAMES LEE LOOMIS and HENRY B. SAWYER, Trustees of the property of The New York, New Haven and Hartford Railroad Company, Debtor,

Petitioners,

v.

WEBSTER AND ATLAS NATIONAL BANK OF BOSTON, Trustee,

Respondent.

BRIEF OF PETITIONERS IN REPLY TO BRIEF OF RESPONDENT.

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Petitioners,

v.

WEBSTER AND ATLAS NATIONAL BANK OF BOSTON, Trustee,

Respondent.

BRIEF OF PETITIONERS IN REPLY TO BRIEF OF RESPONDENT.

(1) *The decision of the Circuit Court of Appeals for the Third Circuit (In re Reorganization of Pittsburgh Railways Company, 111 F. 2d 932, April 30, 1940) is in conflict with the decision below, Respondent's brief page 9 to the contrary notwithstanding.*

(a) Facts and opinion in the Pittsburgh Railways Case.

The decision in the *Pittsburgh Railways Case* was handed down about two weeks later than the decision below and was not reported until after the filing of the petition in the present case. It reversed an order of the United States District Court for the Western Dis-

trict of Pennsylvania which had directed the trustees of the property of a lessee street railway company, operating a street railway system under Section 77B and Chapter X of the Bankruptcy Act, to pay federal income taxes and state income, capital stock and corporate loan taxes falling due during the proceedings by numerous lessors and other underlying companies whose properties were operated by the trustees under leases and operating agreements that the trustees had neither affirmed nor disaffirmed.[1] As in the present case the taxes were not due and owing by the trustees, but were due and owing by the underliers. The order was reversed because it required the trustees to make payment of the underliers' taxes from cash in their hands produced by system operation despite an absence of proof that each underlier had contributed sufficient net earnings to the trustees from which its taxes could be paid. The court left no doubt as to its attitude on this score for it said (111 F. 2d at p. 935):

> ". . . . Until that is done [viz: until proof of earnings is made] any order made by the court would have no factual basis and would, therefore, be arbitrary and possibly confiscatory.
>
> * * *
>
> "The appellees give much weight to the fact that the trustees have in their possession funds derived, as they allege, almost wholly from the operation of the underliers' property, sufficient to pay all the taxes. They contend that it is wasteful of the trust estate to permit interest and penal-

[1] The opinion of the District Court has not yet been officially reported, but see 394 C. C. H. 10,861 Par. 9761 for an unofficial report.

ties to accumulate by reason of non-payment of these taxes. If, however, by reason of the ultimate disaffirmance of the leases the taxes should never become payable, as such, out of the debtor's estate, and if the amount claimed as taxes should be found to exceed the sum justly due for use and occupation the trustees would be in error in so applying the funds in their possession. Furthermore the debtor may succeed in substantiating its claims against some of the underliers.'"[2]

Thus in the Third Circuit no order will be entered that *might* result in taking the property of one person to pay the debts of another *(In re Reorganization of Pittsburgh Rys. Co.)*, but in the Second Circuit an order must be entered that *will* do just that (*Webster National Bank of Boston* v. *Palmer, et al.*). No clearer conflict can be imagined either in reasoning or result.

A petition for writs of certiorari to the Circuit Court of Appeals for the Third Circuit in the *Pittsburgh Railways Case* has now been filed with this Court. The reasons relied on by that petition are (1) conflict with the decision in the present case, and (2) the decision of important questions of Federal law which have not been, but should be, settled by this Court.

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[2] In the present case, as the petition shows (p. 5) and Respondent's brief admits (pp. 4-5), operation of Old Colony and Boston and Providence properties, whose leases have been rejected, has produced *no* net earnings in petitioners' hands for the payment of the taxes. Instead operation of these properties has produced a deficit in excess of $20,000,000 which petitioners have paid from the earnings of other properties. They are seeking prior liens therefor on Old Colony and Boston and Providence properties (R., pp. 186, 187).

(b) The conflict in the meaning and application of Section 124a.

At page 9 of its brief Respondent says no conflict is present because the Circuit Court of Appeals for the Third Circuit failed to mention Section 124a of 28 U. S. C. A. We pass Respondent's tacit assumption here that a conflict can arise only from words, not acts, and its further tacit assumption that an appellate court should cite all statutes in the field of its opinion, whether deemed controlling or not. We do this because the record in the *Pittsburgh Railways Case* and the opinion of the District Court both show beyond doubt that the decision of the Circuit Court of Appeals in that case is as much a decision under Section 124a as is the decision below.

In fact the whole controversy was set off by Section 124a (r., p. 13, par. 15)[3] when the trustees of the Railway Company filed their petition with the reorganization court for advice as to the payment of underliers' and other taxes, alleging that they were operating the system (r., pp. 8, 9) and that taxes were due by the underliers (r., pp. 10-16). The report of the special master quoted the federal statute (r., p. 86), but held nevertheless that the trustees were not obligated to pay underliers' taxes, the leases and operating agreements not having been adopted and there being no evidence to show that the payment of such taxes would not amount to a preference (r., pp. 89, 90, par. 24).[4] Also, the opinion of the District Court (rejecting the

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[3] "r" refers to the record in the *Railways Case;* "R" to the record in the present case.

[4] Paragraph 24 of the master's report is set forth in the Appendix hereto.

master's conclusion) rested squarely upon Section 124a, which it quoted, and upon receivership decisions of the type cited in the present petition (pp., 8, 9). And upon appeal the brief for the underliers (appellees) relied upon the statute and upon *Boteler* v. *Ingels*, 308 U. S. 57 [1939] decided under it. In opposition, the brief of certain tort creditors (appellants) contended that it did not apply to require the payment of taxes of a third person. With this latter view the appellate court evidently agreed. Accordingly it is settled in the Third Circuit that Section 124a does not enlarge the fund out of which taxes are payable or reach the property of persons not liable for the tax. In the Second Circuit an exactly opposite view of the statute is enforced.

(c) The conflict in the meaning and application of the Bankruptcy Act (Sec. 77(c)(6)) and like provisions of Section 77B and Chapter X.

Respondent also purports to find a lack of conflict from the fact that the Pittsburgh Railways system was operated under Section 77B and Chapter X of the Bankruptcy Act which do not specify any requirement, like that in subdivision (c)(6) of Section 77 of the same Act, that under certain circumstances the lessee shall "continue operation [of a leased line] on or for the account of the lessor" until abandonment is authorized (Brief, p..9). The express statement of such a rule would, of course, be out of place in a statute relating principally to the reorganization of business corporations which do not operate "leased lines". With this fact in mind Congress quite evidently intended reorganization courts in proceedings under Chapter X to apply well settled equity receivership rules in solving problems that inevitably arise

during the reorganization of street railway systems comprised in part of leased lines, for all powers and duties of receivership courts not inconsistent with the statutory scheme are expressly given to reorganization courts by the Act (11 U. S. C. A. Chapter X, Section 515).[5] This makes a consideration of equity principles necessary in order to determine whether they resemble or differ from those laid down by Section 77(c)(6).

Many years ago it was settled by this Court that a receiver, acting as he does as custodian of property for the court appointing him and not as agent for the parties (*Quincy M. P. R. Co.* v. *Humphreys*, 145 U. S. 82 [1892]; *Union Trust Company* v. *Illinois Midland R. Company*, 117 U. S. 434 [1886]), is not bound by existing executory contracts or leases unless he adopts them (*Quincy M. P. R. Co.* v. *Humphreys, supra; St. Joseph and St. L. R. Company* v. *Humphreys*, 145 U. S. 105 [1892]; *United States Trust Company* v. *Wabash Western Railway*, 150 U. S. 287 [1893]). It is equally clear, and this Court has long held, that the respective owners of portions of the system of an embarrassed railroad company must bear their own expenses and receive their own earnings accrued during

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[5] Section 515. "Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature."

See also Section 77B(c)(2) of the Bankruptcy Act (11 U. S. C. A., Sec. 207(c)(2)) for similar earlier provisions.

the time they are being administered by a court (*Union Trust Company* v. *Illinois Midland R. Co., supra*). A leading case on this subject in the lower federal courts is *Penn Steel Co.* v. *New York City Ry. Co.*, 198 Fed. 721, 728, 729, 731, C. C. A. 2d, 1912, in which the court said:

> "If a receiver elect to adopt a lease, he becomes vested with the title to the leasehold interest and a privity of estate is thereby created between the lessor and him by which he becomes liable upon the covenant to pay rent. . . . But unless and until he does adopt a lease, there is no such privity and no liability upon the lease."
>
> * * *
>
> "The same principles which give the acquiescing lessor net earnings instead of rentals make it liable for deficiencies when there are no net earnings. In other words, we think that the receiver must be considered as operating the leased road *for the account of the lessor.*"

The rule so announced has come to be known as the "net earnings rule". It had the early approval of this Court, as noted above, and the support of early authority elsewhere (*Ames* v. *Railway Co.*, 74 Fed. 335, 344, C. C. D. Neb. 1896; *Mercantile Trust Company* v. *The Farmers' Loan and Trust Co.*, 81 Fed. 254, 258, C. C. A. 8th 1897, cert. den. 168 U. S. 710). It has since been repeatedly approved in the lower federal courts (*Penn Steel Co.* v. *New York City Ry. Co.*, 216 Fed. 458, 463, C. C. A. 2d 1914, cert. den. 238 U. S. 632; *American Brake Shoe and Foundry Company* v. *New York Railways Co.*, 282 Fed. 293, 298, D. C. N. Y. 1920, affd. 282 Fed. 523, C. C. A. 2d 1922, dismissed, 262

U. S. 736; *Westinghouse Electric and Mfg. Co.* v. *B. R. T. Company*, 6 F. 2d 547, C. C. A. 2d 1925). It was applied in the reorganization of street railway companies under Section 77B in *In re Connecticut Co.*, 95 F. 2d 311, 316, C. C. A. 2d 1938, cert. den. *sub nom. Connecticut Railway & Lighting Co.* v. *Connecticut Co.*, 304 U. S. 571 [1938], and it now applies in the reorganization of such companies under Chapter X (*In re Reorganization of Pittsburgh Railways Company*, at pp. 934, 935).

The essence of the rule is expressed in the statement of Judge Noyes quoted above that "the receiver must be considered as operating the leased road *for the account of the lessor;*" and *Congress incorporated it verbatim into Section 77* through the direction that in the event of rejection and inability of the lessor to operate, the lessee shall continue operating the leased road *"for the account of the lessor"* until abandonment is authorized by the Commission (Sec. 77(c)(6)). Thus in appropriate cases the rule as to leased line operation by reorganization trustees is the same whether the operation takes place under Section 77, Section 77B or Chapter X of the Bankruptcy Act.[6] Congress stated it specifically in Section 77 because it believed the public interest required its application to all railroad bankruptcies where there are leased lines, and failed to state it specifically in Section 77B

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[6] Even apart from special provisions, the reasons for this are clear for:

> "Good sense and legal tradition alike enjoin that an enactment of Congress dealing with bankrupcty should be read in harmony with the existing system of equity jurisprudence of which it is a part." (*Securities and Exch. Comm.* v. *U. S. R. & Imp. Co.*, U. S. [1940].)

and Chapter X because the field of corporate reorganization with which it was there dealing is not limited to a class of corporations that usually operate leased lines. But the rule of Section 77(c)(6) though not specifically mentioned was nevertheless incorporated into Section 77B and Chapter X, through the general provision as to receivership powers, for use wherever the public interest required, and the Circuit Court of Appeals for the Third Circuit was right in applying it to a street railway system composed in part of leased lines that had to be operated.

It follows that no distinction favorable to Respondent can be spun from the fact that the Pittsburgh Railways trustees were not operating the leased lines under Section 77(c)(6) (*cf.* Respondent's Brief, p. 9). The conflict in the two decisions is clear. They are incompatible in the matter of liability of reorganization trustees for taxes of underlying companies operated in proceedings under the Bankruptcy Act. Also it is impossible to read the *Pittsburgh Railways Case* without reaching the conclusion that the Circuit Court of Appeals for the Third Circuit would have disagreed violently with the holding below that Petitioners must pay Terminal Company bond interest from cash in the New Haven estate.

(d) The difference of opinion on matters of constitutional law.

Moreover, the statement that the order of the Pennsylvania District Court directing payment was "arbitrary and possibly confiscatory" (111 F. 2d at p. 935) immediately brings to mind the Fifth Amendment to the Constitution of the United States (see Petition, pp. 13, *et. seq.*) and suggests strongly a dif-

ference of opinion in the two Circuits on the points of constitutional law decided by the court below and raised by the present petition.

(2) *Respondent's brief in opposition shows no reason for withholding the relief sought by the petition.*

It hardly seems necessary to say much in answer to the bulk of Respondent's brief in opposition. Perhaps the Massachusetts Act of 1896 represents, in some of its aspects, an exercise of the State's police power; perhaps, to borrow Respondent's language (Brief, p. 11), "so long as [it] . . . is in force it must be obeyed." But the statute does not run against the property of petitioners as New Haven trustees and it does not authorize, through Sections 124a, 124 or 77(c)(6) or otherwise, any raid on the property of third persons. The court below held it bound petitioners merely because it bound Old Colony and Boston and Providence. It is with this view that we disagree; and there is no need to agree or disagree with Respondent's claims as to the source of the State's power to enact the statute or the requirement of obedience to that power.

The question in the present case is out of what funds shall the taxes and bond interest be paid, not what person shall pay them. No statute settles that question. The Fifth Amendment does. Also, there is no question of abandonment as a palliative to petitioners' dilemma if the judgment below stands (*cf.* Respondent's Brief, pp. 7, 11, 12). Respondent contents itself with mere assertion of the possibility of such relief and does not even answer our argument on this score (Petition, pp. 16, 17). Nor do we find any comfort in the hint that Terminal bondholders will foreclose (Respondent's Brief, p. 11). We wish they

would, but their own self-interest will doubtless continue to restrain them from such action and permit the reorganization of their company to go forward. (Petition, pp. 6, 17). And if practical considerations pointed the other way—if there was a real possibility or probability of voluntary foreclosure action by Terminal Company bondholders—that fact would hardly furnish a reason for payment of these bondholders *from New Haven funds.*

In short, we find nothing in the brief in opposition that shows any reason why this Court should not grant the petition. We still stand on that petition as stating sufficient reasons for review, and we now urge the conflict in the Second and Third Circuits as an additional ground for relief.

HERMON J. WELLS,
Attorney for Petitioners.

J. H. GARDNER, JR.,
Of Counsel.

APPENDIX.

"24. It is uncertain that any of the leases or operating agreements will ever be accepted by the trustees. Unless they be accepted, their covenants for payment of taxes will not bind the estate to pay the taxes of the underlying companies as administration expenses. There is no showing that the amounts, if any, owing to the respective companies for the net earnings of their properties or for the use of their properties by the trustees are proportionate to their taxes or even that in every case they are as much as their taxes. Payments of taxes regarded as payments for such earnings or use might give some companies a greater proportion of their dues than others and might even overpay some. If the debtor's claims (paragraph 17) against some of the underlying companies be meritorious, they may affect the equities. There does not appear to be any exigency which might justify the risk of effecting preferences or overpayments. It does not seem practicable to deal with the underliers' taxes in the mass, or to dispose of them separately upon the facts shown. At present the taxes of the underliers should not be paid by the trustees."